

INDEPENDENCE AND ETHICS OF PUBLIC ACCOUNTANTS

FROM THE VIEWPOINT OF THE S.E.C.

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An examination of Securities and Exchange Commission publications seems to indicate that considerable publicity has been given to the viewpoint of the Commission with respect to the subject of the independence of public accountants and the ethics of the profession. However, a short review of the subject and analysis of commission statements thereon may be appropriate on this occasion.

The Securities Act of 1933 requires that financial statements contained in registration statements filed with the Commission pursuant to such Act be "certified by an independent public or certified accountant." The Investment Company Act of 1940 requires that financial statements filed thereunder be "accompanied by a certificate of independent public accountants." The Securities Exchange Act of 1934 and the Public Utility Holding Company Act of 1936, while not requiring certification of financial statements, provide that the Commission may require certification of financial statements in which event the certification must be made by "independent public accountants." None of these Acts contains a definition of the term "independent" and I think that the defining of this concept was rightfully considered by the Congress as a proper function to be delegated to the Commission, which would, as a result of experience, be in a position to adapt the definition to whatever exigencies the future might hold. Certainly there could have been no doubt among the members of the accounting profession, who had

been educated and trained to regard their independence as a prime criterion of successful public practice, as to the significance and basic objective of the concept. The earliest rules adopted under the Securities Act of 1933 included the announcement that

"The Commission will not recognize any certified accountant or public accountant as independent who is not in fact independent. An accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is connected as an officer, employee, promoter, underwriter, trustee, partner, director, or person performing similar functions."

It would appear that this rule is merely an adoption by the Commission of an accepted code of professional conduct long urged, and we may assume observed for many years, by professional accountants.

In proportion to the large number of certified financial statements filed with the Commission relatively few violations of this rule have come to the attention of the Commission's staff. However, in many instances accountants and their clients have been spared the expense and embarrassment of stop-order or delisting proceedings by obtaining a ruling as to independence prior to filing certified statements. The number and variety of these cases led to a revision of the Commission's rules on independence on November 7, 1942 (Accounting Series Release No. 37), and on May 24, 1943 (Accounting Series Release No. 44), so that the pertinent paragraphs of Rule 2-01 in Regulation S-X now read:

"(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

"(c) In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and that registrant, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission."

At the time the amendment of November 7, 1942 was published a statement was made of which I quote part:

"The amendment makes it clear that, in determining whether certifying accountants are in fact independent as to a particular company, there should be taken into account the circumstances surrounding not only the work done in certifying statements filed with the Commission, but also other work done for the particular company by such accountants, including the certification of any financial statements which have been published or otherwise made generally available to security holders, creditors, or the public.

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"----- Perhaps the most critical test of the actuality of an accountant's independence is the strength of his insistence upon full disclosure of transactions between the company and members of its management as individuals; assension to the wishes of the management in such cases must inevitably raise a serious question as to whether the accountant is in fact independent. Moreover, in considering whether an accountant is in fact independent, such assension to the wishes of the management is no less significant when it occurs with respect to the financial statements included in an annual report to security holders or otherwise made public than when it occurs with respect to statements required to be filed with the Commission."

On January 25, 1944 Accounting Series Release No. 47 was published which presented a summarization of the releases of the Commission on the subject of independence of accountants together with a compilation of hitherto unpublished rulings thereon in cases or inquiries arising under the various Acts administered by the Commission. This release contained the statement that:

"In the case of the great majority of financial statements filed with the Commission no question has been raised as to the independence of the certifying accountant. However, in addition to ----- formal decisions ----- there have been many informal rulings in cases arising under the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940. It is not feasible to present adequately in summarized form the circumstances existing in particular cases in which it was determined not to question an accountant's independence. The ----- compilation therefore includes only representative examples of cases in which an accountant was considered not to be independent with respect to a particular company."

The various Acts administered by the S.E.C. as I have indicated above did not introduce a new idea of independence in the work of public accountants. The New York Stock Exchange under date of January 6, 1935 announced that since April of 1932 all corporations applying for the listing of their securities were asked to agree that future annual financial statements would be audited by independent public accountants and after July 1, 1933 all listing applications from corporations were required to contain the certificate of independent public accountants. The announcement went on to say that representative houses and banks of issue believed the plan to be "sound and consistent with the importance of affording to the public the most complete and accurate information in regard to the financial condition of corporations whose securities are publicly dealt in." The scope of the audit was to be not less than that indicated in the Federal Reserve Board pamphlet of May, 1929 "Verification of Financial Statements." A revision of that pamphlet published by the American Institute of Accountants in January, 1936 was given the title "Examination of Financial Statements by Independent Public Accountants." No definition of the term "independent public accountant"

is given in this document but independence of management, the generally accepted concept, seems implied by the introductory statement that financial statements present a periodical review or report on progress by management and that they reflect a combination of recorded facts, accounting conventions and personal judgments. The revised pamphlet contains the statement

"The soundness of the judgments necessarily depends on the competence and integrity of those who make them and on their adherence to generally accepted accounting principles and conventions. It is for this reason, even more than for a check on the clerical accuracy that an independent review of the statements is desirable."

While lack of independence does not in all cases necessarily lead to unethical conduct, yet where a question of ethics is involved, it is almost invariably the case that the accountant was not in fact independent. For example, an accountant omits a standard audit procedure because his client has requested its omission; or, he certifies financial statements filed with the Commission which are materially different than those contained in the corporation's annual report to stockholders which he has also certified; or, on behalf of a corporation which is not required to file statements with the Commission he certifies financial statements which he knows would not meet the requirements of the Commission. From our viewpoint it is extremely doubtful that the accountant is independent in any of these cases and his lack of independence may be assumed to have caused him to be a party to the presentation of misleading financial statements. This, in our opinion, constitutes

unethical or improper professional conduct. Moreover, if under circumstances similar to these he represents himself to be independent by certifying financial statements filed with the Commission it is our viewpoint that he is lacking in character and integrity.

In the latter part of 1938 the Commission amended its Rules of Practice to prescribe a procedure whereby, in certain circumstances, accountants could be denied the privilege of certifying financial statements filed with the Commission. Prior to that time, numerous statements were filed with the Commission which contained unacceptable certified financial statements and which indicated that the certifying accountants had condoned or failed to object to practices which, in our opinion, were improper. In respect of several of these cases, which resulted in stop-order or delisting proceedings against the corporations by whom the statements were filed, the Commission published opinions wherein the certifying accountants were criticized. In these cases the Commission has followed the practice of informing the appropriate accounting societies and State agencies so that these organizations which have recognized the necessity of maintaining high standards of professional conduct may take appropriate disciplinary action under established codes of ethics. As a result of this procedure the right of at least three accountants to practice was suspended by the agencies having jurisdiction for a period of six months in one and a year in two cases.

Rule II(e) of the Commission's Rules of Practice which, as stated previously, were amended in 1938 to provide a procedure for disciplining accountants who engage in improper conduct in connection with the certifying of financial statements filed with the Commission, now provides that:

"The Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after hearing in the matter

(1) Not to possess the requisite qualifications to represent others; or

(2) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct."

The application of this rule has resulted in the disciplining of certifying accountants in three cases. In two of these cases the accountants were denied the right to practice before the Commission for several months, and in the third case, the accountant was permanently denied such privilege. Proceedings against several other accountants are now under consideration. In all of these cases we feel that the accountant has displayed a complete disregard of the Commission's rules and of proper professional conduct.

There is another area in which the decision of the accountant as to whether he can, or should, permit the use of his name as the accountant certifying to financial statements to be used in connection with a public offering of securities is of fundamental social importance. In a number of recent cases it has appeared that included among the top management of a company were one or more individuals whose business reputations

were questionable, even to the point of headline newspaper notoriety. Inasmuch as a certifying accountant must at best rely to some extent upon representations of management, such cases invite a question as to whether, if a reasonable doubt exists as to the integrity of management an accountant can, with confidence, express an unqualified opinion as to management's financial statements. Indeed, an even more basic question was posed as to such cases by Col. R. H. Montgomery at the fiftieth anniversary meeting of the American Institute of Accountants (of which he was then president). Col. Montgomery said:

"The business man or capitalist who wants to fool the public should not be able to retain a reputable accountant. Isn't the time ripe when he must have one or be prohibited from publishing any financial statements?"

It might be inferred from the title given me for this short paper that there is a difference in the viewpoint of practicing accountants and the S.E.C. with respect to independence and ethics. I am sure that this is not the case and I feel that the views of both the accountants and the S.E.C. may be summed up in the following paragraphs quoted from Mr. George O. Kay's lecture entitled THE ACCOUNTANT AND THE INVESTOR delivered at Northwestern University School of Commerce in 1932:

"To be willing to exercise his judgment objectively and dispassionately the accountant must be a man of high character, prepared to recognize and observe high ethical obligations even to his own immediate disadvantage. To be able to do so he must be free from any relation to the subject matter or to the parties in interest which might cloud his judgment or impair his loyalty to the investors, to whom his paramount duty is owed. As I have indicated, he necessarily stands in some

business relation to the corporation creating the securities and the banking house undertaking their issue, but he should be careful to keep those relations on such a footing as to insure that his freedom of action and independence of judgment will not be affected.

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"I would not have you think that because the investor is not his immediate client the accountant owes nothing to the investor except legal duties and ethical obligations. This is not, of course, the fact. It is the investor that he owes his entire practice in the field of financial auditing, and it is only because the investor exists, and attaches weight to an accountant's report, that the banker employs the accountant's services in this field. And the continued success of the accountant is dependent on his retaining the confidence of the investing public. An enlightened self-interest, therefore, as well as self-respect calls for the maintenance of a proper ethical standard by the practitioner."

REFERENCES

Securities Act of 1933, Schedule A, paragraphs 25 and 26.

Securities Exchange Act of 1934, Sec. 13(a)(2).

Public Utility Holding Company Act of 1935, Sec. 14.

Investment Company Act of 1940, Sec. 30(e).

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